An Assessment of SMEs' Financing by Commercial Banks in Zimbabwe

Stanley Sachikonye[1], Mabutho Sibanda[2]

Abstract: Small-to-medium enterprises (SMEs) play a key role in the world economy and contribute significantly to an economy's output, income and employment. This paper seeks to assess the extent to which Zimbabwe's commercial banks finance SMEs. Document analysis and an extensive review of the literature was undertaken to contextualize and draw a framework of analysis for the study. The literature shows that SMEs are of great socio-economic importance in developing countries but access to financial services for SMEs in Zimbabwe remains low. Zimbabwe's economic challenges since 2000 to dollarization in 2009, the informalization of the SME sector, customers' financial illiteracy and lack of training, lack of collateral security for loans, a high non-performing loans ratio, the lack of understanding of SMEs' needs by banks, the inaccessibility of banks and the general lack of financial innovation are some of the major reasons for the low level of SME financing. A harmonised approach to policy suggestions for SMEs, lending institutions, the central bank and government to ensure the viability and growth of the SME sector are required and outlined. The research helps to formalize the SME sector considering its attendant benefits to the relevant players in the economy.

Keywords: SME financing; dollarization; economic development; commercial banks

JEL Classification: G21; G31; G38

1. Introduction

Small-to-medium enterprises (SMEs) are of great socio-economic importance, especially in developing countries, and they remain the mainstay of almost all economies in the world. SMEs contribute in developing economies by generating employment, offering advanced and innovative products and services through entrepreneurship, enhance international trade through diversification (Hussain, Farooq, & Akhtar, 2012), and promote urbanization (Duan, Han, & Yang, 2009). According to the United Nations Industrial Development Organization (UNIDO (2006), SMEs are believed to be especially effective job creators and enjoy a

[1] Midlands State Univesity, Zimbabwe, Address: Gweru, Zimbabwe, Gweru, Zimbabwe, Tel.: +263 8677 000234, E-mail: ssachikonye@gmail.com.
[2] PhD, University of KwaZulu-Natal, South Africa, Address: King George V Ave, Durban, 4041, South Africa, Corresponding author: mabuthosibs@gmail.com.

reputation for being sources of income and for providing training opportunities as well as important basic services for disadvantaged people.

Worldwide, SMEs' long-term growth and competitiveness have been compromised by the chronic and often acute constraints on their access to formal-sector finance, and in developing countries there are also other systemic and institutional problems (Wattanapruttipaisan, 2003b). Access to financial services is vital in developing a vibrant SME sector in any economy. According to the International Finance Corporation (IFC) (2016), in most emerging markets access to financial services for SMEs remains severely constrained and this is the basis for the renewed focus on supporting SMEs worldwide.

In Zimbabwe, the operating environment, since 2000 through to the adoption of the multicurrency system in 2009, has experienced a plethora of challenges. These include deteriorating agricultural sector output; a yawning trade deficit; subdued foreign capital inflows; a heavy external debt burden; acute power shortages; limited fiscal space, low domestic output and de-industrialization; plummeting savings and money supply growth; and unprecedented high non-performing loans ratios in the banking sector. These challenges have resulted in serious liquidity shortages, which erode banks' ability to underwrite business, particularly for SMEs, which are considered risky. The financial services sector in Zimbabwe has a significant role to play in the promotion of the development of SMEs (Dhliwayo, 2014). In the Zimbabwean context, SMEs need more financial and technical support if meaningful economic growth is to be achieved.

2. Objectives of the Study

This study seeks to:

a) Assess the importance of financing of SMEs by commercial banks in Zimbabwe.

b) Assess the extent of financing of SMEs by commercial banks in Zimbabwe.

c) Provide policy recommendations on how to enhance the role of the relevant stakeholders in financing SMEs in Zimbabwe.

3. Review of the Literature

Access to finance is a key constraint to SME growth, and without it many SMEs struggle and fail to grow (World Bank, 2015a). The phenomenon of SME financing difficulties exists in many countries in the world, even in the developed countries with relatively sound financial systems (Jiang, Lin, & Lin, 2014), yet access to financial services is vital in developing a vibrant SME sector in any economy (International Finance Corporation, 2016).

SME finance, like SMEs themselves, is exceptionally diverse and complex and faces unique challenges (Nassr & Wehinger, 2014). The current credit gap for formal SMEs is estimated to be United States dollars (USD) 1.2 trillion; the total credit gap for both formal and informal SMEs is as high as USD 2.6 trillion (World Bank, 2015a). Yet, debt in the form of overdraft facilities is primarily needed by the smaller firm to cover working capital requirements, with intermittent need to finance replacement or expansion investment (Cressy & Olofsson, 1996). SMEs are often unable to provide immovable property required by the banks, and there is a lack of alternative funding, such as venture capital, angel investors, and government and NGO support (Small & Medium Enterprises Association of Zimbabwe, 2015).

The World Bank is increasingly looking to develop more innovative forms of SME financing. (World Bank, 2015a). Some countries use cluster funding, whereby banks identify and group Micro Small and Medium Enterprises (MSMEs) in a locality involved in similar business activities into a cluster and then capacity building and credit programmes are tailored to a cluster's specific needs. Developing countries, such as Bangladesh, have successfully used the cluster model in the development of MSMEs (Mangudya, 2016). Also, Governments in both developed and developing countries have recognized that SMEs struggle to access external financing, which may negatively affect their crucial role in achieving national development goals, thus many governmental initiatives and programmes have been implemented to ensure that SMEs easily access financing (Abdulsaleh & Worthington, 2013). Government official schemes introduced either by government alone or with the support of donor agencies have been seen to have the capability to ease access by SMEs to additional credit (Boocock & Shariff, 2005).

The World Bank reported that Zimbabwe's financial sector has been subject to several distress periods in the last 10 years, including periods of hyperinflation and the national currency collapse, which led to the adoption of a multicurrency system in 2009. This system resulted in financial sector activity shrinking, a scenario that affected the level of SME financing by banks. The same report also revealed that banks in Zimbabwe face several systemic challenges, which include general illiquidity in the market; lack of long-term capital; the high cost of funds, which are only partially mobilized internally and thus still heavily rely on external, often more expensive sources; low capitalization; and a high level of non-performing loans. Credit risk is a significant concern for banks, increasing the reluctance to lend (World Bank, 2015b), with SMEs suffering more from credit rationing than large corporates (Duan, Han, & Yang, 2009). International and regional lines of credit are few and subject to a high risk premium, reflecting the perception of

Zimbabwe as high risk due to the existing external debt payment arrears and debt overhang (Malaba, 2014).

In 2012, Zimbabwe joined the Alliance for Financial Inclusion (AFI) network. According to the RBZ (2016), one of the most pronounced trends currently observed among the AFI's member countries is the increasing focus on the development of national financial inclusion strategies. With effect from January 2015, the government initiated the process of bringing the Small and Medium Enterprises Development Corporation (SMEDCO) and Infrastructural Development Bank of Zimbabwe (IDBZ) under the purview of the RBZ. SMEDCO's mandate is to promote the development of MSMEs and cooperatives by providing financial and capacity-building programmes.

In March 2016, in conjunction with the government, RBZ launched the Zimbabwe National Financial Inclusion Strategy (2016-2020), whose objective is to deepen financial intermediation for the marginalized and the unbanked to have access to appropriate financial services during the strategy period of 2016-2020. Unfortunately, the cash shortages that bedevilled the country during this period resulted in farmers withdrawing all their cash once deposited, with very little savings. Nevertheless, in the long term this measure will benefit the country in terms of financial inclusion and financing of SMEs, which includes farmers.

4. Methodology

This study makes an assessment of the level of financing of SMEs in Zimbabwe by commercial banks. An extensive review of the literature was undertaken to contextualize the study and draw some insights from both the theoretical and empirical literature that provided a framework for analysis for the study. Various financial institutions' reports, books and journal articles related to the SME sector were reviewed to get a general understanding of the framework of how and at what level commercial banks finance the SME sector. This study borrowed heavily from previous studies on the SME sector that have been done in Zimbabwe and elsewhere. Specifically, the views, perceptions and information from these reports and research papers were compared and contrasted. Inferences were made and recommendations drawn.

5. Discussion

In Zimbabwe, as at 31 December 2015, there were 19 banking institutions made up of 13 commercial banks, 1 merchant bank, 4 building societies, 1 savings bank, as well as 155 microfinance institutions (MFIs) and 2 development finance institutions (Reserve Bank of Zimbabwe, 2016). In addition, banks have undertaken various strategic initiatives aimed at enhancing support to SMEs such as: negotiating off-shore lines of credit; introducing viability-based lending; technical training of bank staff in SME financing; providing SME training workshops; and customizing credit policies to suit SMEs' needs (Dhliwayo, 2014).

Banking in Zimbabwe is mainly driven by transactional and savings products, with lending primarily consisting of consumer loans (not production loans).

According to the Labour and Economic Development Research Institute of Zimbabwe (LEDRIZ) (2012), the financial system in Zimbabwe has been excluding people in the informal sector, particularly those in rural areas. Some of the challenges facing SMEs identified by the RBZ included the perceived high risk profile of SMEs and the history of not repaying loans due to an entitlement culture that emanated from receiving free funds from government. However, the problem with accessing loans from MFIs, which are now able to offer loans to SMEs particularly in rural areas, is that they charge exorbitant rates and offer very short tenors, making SME businesses unviable.

Owing to the risky nature of SMEs, over the years, banks have been indirectly supporting SMEs through financing contract growing schemes carried out by large corporations, particularly for tobacco, cotton and sugar (Malaba, 2014). The low level of SME financing in Zimbabwe has been observed to be caused by various shortcomings of SMEs, banks, the regulator and government, as follows.

SME Shortcomings

Several authors and sources have identified the following as shortcomings:

a) Lack of viable business models and operating in struggling or overcrowded industries. SMEs usually operate for short periods, with a high probability of exiting from the market, which scares away lenders. About 85% of SMEs in Zimbabwe fail (60% in the first year and 25% in the first three years) (Mudavanhu, Bindu, Chiguswa, & Muchabaiwa, 2011).

b) Most SMEs are unable to provide collateral security demanded by banks.

c) Lenders are unwilling to fund start-ups or businesses with no track records, unless there is a very strong business case.

d) Many SMEs are owner or family-operated, hence they fail to keep business and personal finances separate. Financial records help demonstrate business performance to both the enterprise owner and lender.

e) High default rates caused by diversion of funds from the intended business purpose characterize many SMEs, hence banks exercise extreme caution when lending to them.

f) Lack of banking records which provide third party confirmation of what accounting records say about a business' earning capacity. This helps when assessing a loan application.

g) Most SMEs lack requisite skills and technology to produce standardized products and/ or services that can compete in the market thus threatening their survival.

h) Many SMEs lack skilled manpower and managerial capacity, resulting in limited ability to sustainably run the enterprises. They also lack good internal controls and accounting systems, relevant licensing and registration, and in the case of medium-sized enterprises governance structures such as advisors, board of directors, diversified shareholding, professional staffing structures and general good business practice.

i) The SME sector is fragmented, characterized by small business enterprises. The absence of vibrant industry associations results in inadequate representation on industry issues.

Lending Institutions Shortcomings

Listed below are aspects of banking that impact negatively on SMEs:

a) The major barriers to banking include the costs of products, which are comparatively high (Finmark Trust, 2014). Banks charge a risk premium on loans to SMEs, resulting in high borrowing costs. Effective lending rates by commercial banks in Zimbabwe ranged from 13-38% per annum in January 2014 (World Bank, 2015b). This compares unfavourably with credit interest on current accounts of 0-5%.

b) The unavailability of bank accounts due to complicated procedures as well as documentation required lead enterprise owners to open personal accounts (Zimbabwe Economic Policy Analysis and Research Unit & Bankers Association of Zimbabwe, 2014).

c) Unfavourable loan terms such as pricing and loan tenors (Zimbabwe Economic Policy Analysis and Research Unit & Bankers Association of Zimbabwe, 2014).

d) Zimbabwe lacks a coordinated financial literacy strategy and no assessment has been made of financial capability levels (World Bank, 2015b).

e) Limited branch network resulting in SMEs remaining unbanked or underbanked.

f) Banks' risk-averse behaviour adopted by banks following the increase in the non-performing loans (NPLs) ratio.

g) Lack of understanding of SME nature, operations and needs by banks hampers their ability to assess the business viability and financing needs of SMEs, thereby making banks fail in offering appropriate banking products to suit SME needs (Dhliwayo, 2014).

h) SME financing is cumbersome and administratively expensive owing to the large number of SMEs and the small loan amounts and transactions that they require, resulting in banks shunning SMEs (Duan, Han, & Yang, 2009).

Central Bank

Here follows some issues that require attention from the central bank in Zimbabwe:

a) Consumers in Zimbabwe have limited recourse rights and there are very limited avenues for third party dispute resolution (World Bank, 2015b).

b) There are no credit reference bureaus in Zimbabwe to provide borrowing history and to track defaulters, thus compounding the risk-averse behaviour of banks.

c) Unemployment, low income levels and unaffordable financial products/services remain key constraints on people becoming financially included. Financial exclusion is particularly high in rural areas possibly due to limited accessibility to banks and formal salaried employment opportunities (Finmark Trust, 2014).

Government Shortcomings

In order to better support SMEs the government should take the following concerns into consideration:

a) Address SME concerns and accord priority to SMEs to enable them contribute to the betterment of the economy (Nyamwanza, Paketh, Mhaka, Makaza, & Moyo, 2015).

b) The perceived country risk of Zimbabwe, worsened by unfavourable indigenization laws requiring locals to own at least 51% of companies, militates against foreign directive investment, which has been very low (Bezuidenhout, 2015).

c) Lack of support in terms of legalizing and regulating SMEs.

d) The heavy-handed approach by the Zimbabwe Revenue Authority (ZIMRA) in collecting tax has pushed SMEs into the informal sector.

6. Policy Suggestions

To SMEs:

a) Present themselves to all stakeholders as professional and viable businesses;

b) Educate themselves on bank requirements and be able to prepare credible project proposals;

c) Put in place good corporate governance structures;

d) Keep records of all business activities and produce financial statements;

e) Bank all the money so that a good track record is built;

f) Move away from cash transactions and adopt plastic;

g) Adopt a saving culture. Use savings to buy fixed property, which can then be used as collateral security to access bank credit;

h) Legally register their companies and ensure all due taxes are paid;

i) Develop guarantee funds that provide collateral for deserving SMEs;

j) Work together as groups and register effective associations. This co-operation helps in knowledge transfer, developing and accessing markets, attracting investors and accessing bank loans.

To Lending Institutions:

a) Understand the dynamics of SMEs;

b) Develop more innovative financing structures and appropriate products for SMEs;

c) Provide advisory services to SMEs;

d) Increase accessibility, and this includes using technology to reduce costs of banking products. Copying successful models such as Mzansi accounts in South Africa and introducing agent banking and leverage mobile phone capabilities could help;

e) Act as agents for groups that pool resources together and use these resources as collateral when they lend to group members;

f) Introduce cluster funding;

g) Introduce leasing as an alternative source of funding, which reduces the need to provide collateral security by SMEs.

To the RBZ:

a) Expedite the launch of the credit reference bureau;

b) Implement systems that protect financial consumers in order to build trust in the financial sector and encourage responsible financial inclusion;

c) Successfully implement the Zimbabwe National Financial Inclusion Strategy;

d) Work with government to provide empowerment credits to foreign-owned banks that finance SMEs up to a certain threshold.

To Government:

a) Put in place policies that bring about an enabling legal, regulatory and operating environment for SMEs to grow and be formalized;

b) Maintain consistent policies so as to attract foreign investors;

c) ZIMRA should accommodate SMEs and give tax holidays or concessions where necessary so as to allow SME growth and development;

d) Work with international lending institutions such as the World Bank, which can help establish offshore lines of credit as well as programmes;

e) Work on improving indigenization laws so as to attract foreign investors;

f) Work closely with SME associations, the donor community and banks to address market failure issues through capacity building of SMEs;

g) Work with local authorities to legalize and regulate SMEs operations through designating specific zones for their activities;

h) Introduce financial education from primary school right up to tertiary level;

i) Capacitate and capitalize SMEDCO so be able to adequately finance SMEs;

j) Ministry of SMEs to work and align with the RBZ and financial institutions in crafting policies and activities that promote SMEs;

k) Capacitate and capitalize the RBZ to implement, track and monitor adopted strategies since these have been blamed for failed strategies.

7. Conclusion

SMEs contribute significantly to developing countries' economies, yet they remain with hugely untapped potential owing to a myriad of challenges, chief among them being lack of finance. Commercial banks in Zimbabwe therefore have a critical role to play in developing SMEs, which can become the basis of the country's economic recovery. There are several kinds of financing options that can be adopted for financing SMEs. There is the need to formalize SMEs as formalized SMEs benefit the entire economy – the government can earn tax revenue, the SMEs can access formal credit from banks and grow, foreign investors can invest in formal SMEs and banks can lend profitably to SMEs. The success of SMEs is anchored by the active contribution of the four main players, which are the SMEs, financial sector, the central bank and government. It will be constructive for all these main players to integrate and work together in other non-financial interventions, such as training, capacity development, cluster development, tax benefits for funding specific sectors and the general inclusion of SMEs in business activities. Such initiatives will assist SMEs in being innovative, operate efficiently and economically and to reduce the risk of fraud, default and business failure. Such developments will enable banks to profitably lend to SMEs.

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